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TAGS: EFIN ECON PGOV FR
SUBJECT: FRENCH EONOMIC GROWTH SLUGGISH

Ref: Paris 5694

¶1. SUMMARY. French GDP increased a low 0.4% (annualized) in the second quarter. The rise in oil prices and the euro in the third quarter caused fears that 2005 economic growth could be lower than government forecast of 2.0%. Eventually, the government reduced its GDP growth forecast to 1.5-2.0%. On September 1, just before the end of the 100-day period to restore confidence, the Government is expected to introduce new measures to spur economic growth (septel). These are likely to increase the central government budget spending, and thus the already-bloated budget deficit. END SUMMARY.

GDP Growth Low in Q-2

¶2. On August 19, the National Institute for Statistical and Economic Studies (INSEE) confirmed its August 12 flash estimate of a 0.4% (annualized) increase in Q-2. GDP growth weakened in Q-2 compared with 1.6% (annualized) in Q-1 (revised upward from 1.2%). The Q-2 GDP growth is lower than private-sector economists' forecasts of 0.8% (annualized) and fell well below the 2.0% (annualized) Bank of France's forecast. In 2004, GDP had increased 2.1%, notably due to the 2.8% (annualized) Q-4 rebound.

Consumption and Corporate Investment Decreased in Q-2

¶3. The poor Q-2 performance was mainly due to a 1.2% (annualized) drop in household consumption in Q-2, the biggest decrease since 1996. Consumption was undermined by worries about oil prices and unemployment. The unemployment rate remained at a five-year high of 10.2% in April and May, edging down to 10.1% in June. (Macro-economic analysis of the labor situation will be provided in a separate cable.)

¶4. Corporate investment decreased 1.6% (annualized) as non-financial firms significantly reduced their investment (minus 4.8% annualized). Surveyed industrialists said that rising oil prices and the decrease in the euro in the first half did not encourage industrialists to invest. The capacity utilization rate remained low (82.6% in June).

Q-2 GDP Growth was led by Inventories and Real Estate Investment ...

¶5. Inventories had a significant 0.4% contribution to GDP in Q-2, notably because of durable increases in raw materials prices. GDP growth excluding inventories would have been negative, minus 1.2% (annualized). Real estate investment increased 2.8%, amplifying the real-estate bubble.

. . . and Exports

¶6. Exports rebounded in Q-2, increasing 4.0% (annualized) after decreasing in Q-1, while imports continued to increase, up 5.3% (annualized). Based on Customs data, exports hit a record of 175.8 billion euros in the first half as exports surged 30 billion euros in April and May, partially due to the sales of 107 Airbuses (6.5 billion euros) and capital goods. The French foreign trade posted a high 11.2 billion euros deficit in the first half due to an increase in imports, notably imports of energy (17.2 billion euros). The energy deficit was responsible for around 50% of the increase in the energy deficit in the first half.

¶7. Foreign Trade Minister Christine Lagarde stressed that "continued bearish economic export growth in the euro zone

was harmful to French foreign trade." Weak exports to France's two main trading partners, Germany and Italy, dragged down the overall gains. Lagarde blamed the increase in the euro in 2003 and 2004 for harming French export-orientated companies. Commentators stressed that Germany (unlike France) benefited from strong demand for its hefty industrial products.

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Government Revised Downward GDP Growth Forecast to 1.5-2.0%
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¶8. INSEE's chief economist Michel Devilliers said "we are in a phase of a not so great quarter, but it will be followed by a progressive recovery." His comment echoed that of the European Commission, which forecast on August 11 an acceleration in the euro zone growth to the fastest pace in almost two years at the end of 2005. It said that the European central bank, which held its benchmark interest rate at a six-decade low of 2%, would help underpin a recovery in the euro zone.
¶9. Finance Minister Thierry Breton said "we clearly sense, for example with recent business confidence data, industrial production and company creation, that indicators are beginning to return to green. We are confident for the second half." Nonetheless, on August 31, he admitted that 2005 economic growth was below 2%. He said the government revised its GDP growth forecast to 1.5-2.0% from 2.0%, reiterating that "the worse was behind us" as the unemployment rate dropped below 10% mark, to 9.9% in July, hitting the lowest level in two years.

IMF Revised Downward 2005 Forecast to 1.75%

¶10. In July, IMF revised its forecast of the 2005 French economic growth to 1.75% from 2%, and forecast GDP to increase slightly above 2% in 2006 due to improved business climate and increased domestic demand benefiting from an increase in the euro. That said, IMF warned "important uncertainties" related to oil prices and possible sluggishness of foreign demand if France's European partners subsisted. On their part, private-sector economists warned about rising oil prices, weak job market and strong euro, which would limit economic recovery in the second half and restrict 2005 GDP growth to 1.5%.

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Main Downside Risks: Increasing Euro, High Oil Prices, Lack of Competitiveness
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¶11. Some economists deemed exports would benefit from the delayed effects of the weakness of the euro, which declined 9% in the first half. Nonetheless, the recent rise in the euro (up to USD 1.2468 on August 11) and in France's foreign trade deficit renewed fears about a negative impact of a strong euro on export growth.

¶13. The continuous rise in high oil prices above 65 USD a barrel has been causing concerns about the fragility of economic recovery through its impact on prices consumption, investment, and imports. Lagarde estimated that the energy trade deficit could increase to 40 billion in 2005 from USD 29 in 2004. Regarding the preparation of the 2006 budget, Breton said the government set average oil price of USD 50 per barrel (versus USD 36 in the 2005 budget). Although energy prices for consumers are surging (up 12.5% in July compared with July 2004), inflation remained under control since consumer prices increased 1.7% in July compared with July 2004.

¶14. Economists, notably well-respected Head of the Government Economic Analysis Council ("Conseil d'Analyse Economique") Christian De Boissieu blamed France's weak trade performance on a lack of competitiveness. He highlighted that the French industry was unable to benefit as its competitors from increased demand from emerging economies. The Government commissioned a report to the Council in December 2004. The report will be delivered by the end of the year.

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Rise in Oil Prices Cause Reactions from Politicians, Unions And Professionals
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¶15. Because of the surge in oil prices, the socialist party, the center-right UDF, some ruling-majority UMP members, and unions of transport professionals called for fuel price concessions. Socialists called for the reactivation of the variable tax on petroleum products (Taxe Interieure sur les Produits Petroliers Flottante -"TIPP flottante") to limit the impact on consumers of high oil prices. Fuel levies (74% tax on gas and 67% tax on diesel

paid by motorists) are split between value-added tax of 19.6% and a volume-based TIPP, which is forecast to raise E 20 billion in 2005. The variable tax had been introduced by the former socialist government, but was abolished by former Prime Minister Jean-Pierre Raffarin in 2002. Socialists advocated that not reactivating the variable tax was harmful to consumers, and therefore to economic growth. At the other end, the Greens and the National Federation of Associations of Transport Users were opposed to a decrease in the TIPP, arguing that drivers must be made aware of their responsibilities, and were favorable to a decrease in consumption of oil products.

¶16. Rising oil prices may give unions new arguments to protest unless the government takes action to boost jobs and real incomes. Left unions FO and CGT leaders had already planned to demonstrate against the new type of hiring contract that allows companies of up to 20 employees to lay off workers anytime during the first two years of employment (Paris 5694).

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Government Will Not Reactivate Floating Tax on Oil Products
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¶17. In an August 16 press conference, Prime Minister Dominique de Villepin ruled out a reactivation of the floating TIPP, arguing it was "extremely expensive" for the GOF and "for a relatively limited impact for the consumer." He said he preferred measures to encourage job growth as opposed to increased consumption of gasoline and other "polluting products" since the government made the fight against the global warming one of its priorities. Villepin said he would be careful that measures would help sectors deal with higher oil prices, and promised that excess revenues from tax on oil products will be returned to low-income workers, and to sectors the most exposed to the recent surge in oil prices, notably transport professionals. An independent commission will assess the amount of excess revenues from tax on oil products at fall. Finance, Transport, Ecology and Industry ministers will participate in a round table to evaluate the situation. Villepin urged oil companies including Total to increase refinery capacity, saying supply shortage caused price increases. He also asked French motorists "to show a spirit of responsibility" by reducing their average speed by 10 km per hour, which, he said, would save money.

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Government Prepares a New Set of Measures to Spur Growth
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¶18. Villepin, who promised after taking office in June to restore confidence to the French within 100 days (by September 8), said that the government was preparing a set of new measures to boost economic growth. He will unveil his program on September 1. According to the press, the government could encourage employees' stock holding, wage negotiations by sector, job creation through tax incentives, and would finance measures with future privatization proceeds.

Comments

¶19. The Q-2 low GDP growth and rising oil prices are contributing to doubts about the Government's ability to spur economic growth in 2005. The government has already accounted for this situation since Villepin warned about a new program to be announced September 1, just a week before the end of the 110-day period, and eventually admitted that GDP growth was more in the 1.5%-2.0% range than close to 2.0%.

¶20. The government is taking measures although its room for maneuver is limited by a bloated government deficit and debt. Measures are likely to swell central government budget spending since the bulk of 2005 proceeds are used to cut public debt.
STAPELTON